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CHINA'S FREE TRADE RELATIONSHIP WITH THE UNITED STATES: ECONOMIC BOON OR "UNRESTRICTED WARFARE"

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ABSTRACT

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This paper examines the emergence of China as an economic power in Asia. Both major U.S. political parties have endorsed a policy of extensive economic engagement with China as being in the nation's interests. However, there are aspects of Chinese economic behavior that indicate the United States should proceed with caution.

This paper reviews the nature of the U.S. – China free trade relationship and the impact of that relationship on U.S. national security interests in the still evolving post-Cold War world. In order to put Chinese economic strategy in perspective and to advance understanding of China's long-term strategic objectives, China's economic strategy is examined relative to the Opium Wars and the recently published Chinese concept of "Unrestricted Warfare." Other issues examined include implications of China's exercise of its economic power in the Asia-Pacific as it establishes regional trade alliances; United States strategic vulnerabilities created by the interdependent effects of a struggling economy and record budget and trade deficits – while financing the Global War on Terror; and China's pattern of economic opportunity denial and resource dominance in Asia.

This paper concludes that the United States should engage China in a free and open trade relationship in a way that denies China opportunities to exploit that relationship in ways detrimental to U.S. National Security Interests. In this regard, a recommendation to employ a carefully crafted strategy of "Strategic Pushback" is offered. This proposed strategy is focused on the concerted strengthening of the U.S. economy, strengthening U.S. relationships with the countries of Asia and commitment to the maintenance of a dominant U.S military presence in the Asia-Pacific through the year 2050.

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> "If the advantage to us is great of a China open to commerce, the danger to us and to her is infinitely greater of a China enriched and strengthened by the material advantages we have to offer, but uncontrolled in the use of them."
>
> —Alfred Thayer Mahan

China's accession to the World Trade Organization in December 2001 was a cause for celebration among advocates of free trade and globalization. For over two decades, since Chinese Premier Deng Xia Peng's implementation of the "Four Modernizations" – agriculture, industry, science and technology, and military – China's economy has been growing and the government has been slowly – but steadily – adopting Western market oriented economic norms with the objective of facilitating China's integration into the global economy. Chinese efforts at economic modernization have yielded significant results. While the average world economic growth is expected to hover at approximately 3.5% per annum for the foreseeable future, Chinese economic growth for 2003 is projected to be nearly 8%. [1] Additionally, projected sustained yearly economic growth of 6-8% per year is expected to further expand China's market potential by increasing average Chinese per capita income by 250% from $1,300 to $4,550 by 2020.[2] These economic indicators are particularly significant given that China's population by 2020 is expected to exceed 1.38 billion. [3] In view of the dynamics of the global economy and the opportunities afforded by the potential of the Chinese market, a U.S. national interest should be engagement of China in free trade to the greatest reasonable extent. However, as we engage China, we should as well carefully consider China's long-term strategic objectives – including her motives and future intentions as she emerges as a stronger player in the global economy. There are indicators that the United States should proceed with caution. As much as China's economic emergence represents opportunity for the United States, it also represents a significant new geopolitical challenge for the future of the United States as a world power in general and as a power in Asia specifically.

CHINESE LONG-TERM STRATEGIC OBJECTIVES

Many believe that China's long-term strategic objectives center on national unity and regional hegemony. As the U.S. engages China politically and economically, it should be aware of China's overall long-term objectives and the impact of China's strategy for achieving those objectives on the United States' ability to safeguard and advance its core strategic interests - maintaining its physical security, bolstering its economic prosperity and promoting its values. China's strategy focuses on achieving its grand strategic objective of restoring the "Middle Kingdom" – the Chinese ambition for regional hegemony. This means China wields sufficient economic power and – by extension – political power to assure that no major decision can be made in Asia or about Asia without Beijing's approval or acquiescence. If China acquires such regional dominance, her ascension could lead to a gradual diminution of United States influence and credibility in Asia, culminating in a U.S. withdrawal from any role in maintaining and fostering Asian security and stability. Yet another scenario might be the gradual establishment of an environment in which U.S. interests are permitted to prosper in Asia but only at Beijing's pleasure. This Strategy Research Paper (SRP) examines the prospective economic component of China's overall strategy to achieve its objective of restoring the hegemony of the "Middle Kingdom." To understand 21st Century Chinese strategy, we should consider the past two centuries of Chinese economic relations with the West.

THE OPIUM WARS AND CHINA'S 21ST CENTURY STRATEGIC OBJECTIVES

Prior to 1840, China strictly controlled its contact with the outside world.   Its foreign trade relationships were organized into the "Canton System," so called because only the port of Canton was open to foreign trade. There, western merchants were permitted to deal only with government appointed merchants called "Gong Hang" (officially authorized firms) who monopolized Western trade.

The Chinese had two main reasons for imposing such strict limitations on trade. First, China's foreign policy was dominated by their sense of superiority. Central to this superior attitude, was the Chinese concept of the "Middle Kingdom." The Chinese believed that the Heaven was round and the Earth square. The Heaven projected its circular shadow onto the center of the Earth. The area under the shadow, "Tian Xia" (Zone beneath the Heaven) was China itself. Hence, China was the Heavenly "Middle Kingdom." The corners of the square (Earth) not under the celestial emanation were ruled by foreign "yi" - barbarians. Thus, to the Chinese, foreigners could not be on equal terms with the Emperor, the "Son of Heaven," and his children, Chinese citizens.   Economically, this sense of superiority was reinforced by the insular nature of the Chinese economy which was based on urban handicraft and rural homesteading.[4]

The second – and most important – reason the Chinese Government so strictly limited trade was its desire to protect itself. In China, instability often flourished when external threats exacerbated internal disturbances. The Manchu rulers themselves used civil unrest in China to conquer China and set up their Qing Dynasty in 1644. The Manchu could not risk foreign intrusions that may help to overthrow them. The Manchu feared foreigners would discover

China's weaknesses, but they were even more afraid that the Chinese people might collaborate with them.

Despite such strict limitations, Chinese foreign trade increased significantly during the late 18th and early 19th Centuries. As western purchases of high quality Chinese tea and silk grew, western countries found themselves with large and rising trade deficits with China because the Chinese showed little interest in western products. Finally, in 1820, the West found a product which would sell in China, opium.

Opium was first manufactured in China for medicinal purposes at the end of the 15 th Century. In 1729, alarmed at the debilitating effect of opium use, the Emperor prohibited the sale of opium mixed with tobacco and banned opium-smoking houses. Selling opium was "classed with robbery and instigation to murder, and punished with banishment or death." [5] Still, opium smuggling developed rapidly along China's south coast. In 1820, 9,708 chests of opium were smuggled into China (a chest contained approximately 135lbs of Opium): By 1835, that number had increased to 35,445 chests, an increase of over 350%. The results were devastating to Chinese society; virtually all men under 40 smoked opium, the entire army was addicted. [6] The opium trade soon turned the western trade deficit with China into a trade surplus. China could not export enough tea and silk to balance the deficit. Instead, the balance was made up by the export of highly valued Chinese silver. In 1839, Chinese opium smokers spent 100 million taels (an old Chinese monetary unit equivalent in value to 1 1/3 ounces of standard silver), while the government's entire annual revenue totaled only 40 million taels. This drain of silver severely weakened the Chinese Government. In 1839, an unnamed Chinese official predicted, "If we continue to allow this trade to flourish, in a few dozen years, we will find ourselves not only with no soldiers to resist the enemy, but also with not money to equip the army."[7]

In 1839, growing ever more alarmed at the economic and social effects of opium addiction, the Emperor sent a special commissioner, Lin Ze-xu, to Canton to eradicate opium smuggling. Employing a "take not prisoners" approach, Lin effectively decapitated the smuggling trade in Canton. In addition to attacking the illicit Opium trade, Lin aggressively pursued foreigners accused of committing crimes on Chinese soil. When a Chinese man was killed at the hands of a group of drunken British sailors in Kowloon (a mainland village near Hong Kong), Lin demanded that the British hand over the accused men for trial in Chinese courts. Citing the doctrine of extraterritoriality, the British held that a British subject accused of a crime in China could be tried by the court of his nation's consulate in China, not in a Chinese court. The accused men were tried by Captain Charles Elliot, the British Chief Superintendent of Trade in Canton. When Lin demanded that the men be delivered to Canton to be tried in a Chinese court, Elliot refused, assuring him that the men would be appropriately punished when they returned to England. To force Elliot to submit to his demands, Lin ordered a halt to delivery of all supplies to British ships anchored at Macao. Freshwater springs known to be used by the British at points along the coast were poisoned. On September 4, 1839, British ships attacked three Chinese junks attempting to prevent a British party from going ashore at Kowloon to obtain water and supplies. The crisis continued to build and finally erupted into the First Opium War on November 3, 1839 when British Warships approached the Chinese fleet and demanded supplies and the immediate resumption of trade. After the Chinese dismissed the British demands, the British attacked the Chinese fleet sinking five war junks and damaging several others.[8]

THE TREATY OF NANJING

The first Opium War was concluded in August 1842 by the Treaty of Nanjing. Key provisions of this treaty (and its supplements in July and October 1843) were:

- The issue of Extraterritoriality was settled: All British citizens would be subject to British, not Chinese, law if they committed any crime on Chinese soil. Furthermore, any Chinese who either dealt with the British, lived with them, or were employed by them were also exempted from Chinese law.
- Five ports would be opened to trade: Canton, Shanghai, Foochow, Ningpo, and Amoy.
- One Royal Navy ship would be stationed at each Treaty Port.
- The Chinese would pay the British a war indemnity of 21 million Mexican dollars.
- The British would no longer have to pay tribute to the Imperial Administration.
- China would have to negotiate all customs duties with other countries.
- Chinese import duties were lowered from 65% to 5%.
- The Chinese would provide accommodations for Western merchants and their families.
- China ceded Hong Kong to the British.
- The British were given "Most Favored Nation" trade status extending to Britain any privilege held in China by any other country. This provision was later extended to all countries dealing with China.[9]

THE SECOND AND THIRD OPIUM WARS

In 1856, tensions between the Chinese and western countries again came to a head. The British and French were incensed by what they perceived as Chinese intransigence in restricting trade in the Treaty Ports. For their part, the Chinese were angered at the wholesale export of Chinese nationals to America and the Caribbean to work at what was considered slave labor. These tensions led to the Second Opium War which continued as a series of skirmishes until 1858 when it was terminated by the Treaty of Tianjin which further humiliated and weakened the Imperial Chinese Government by forcing China to open eleven more ports, permit foreign legations in Beijing, sanction Christian missionary activity and legalize the importation and consumption of opium. In 1859, China attempted to block the entry of foreign diplomats into Peking sparking the Third Opium War. During this war, British Naval Forces ravaged the Chinese coastline and British and French forces briefly occupied Peking and burned the Imperial Summer Palace. The Third Opium War was brought to a close in 1860 by the Conventions of 1860 which forced China to reaffirm the provisions of the Treaty of Tianjin.[10]

HUMILIATION AND SHAME: THE EFFECTS OF THE OPIUM WARS ON CHINA

The Opium Wars has four effects on China:

- <u>China became a semi-feudal, semi-colonial state</u>. Western countries and interests were not subject to Chinese law and China lost control of its domestic and international trade.
- <u>Chinese territorial integrity and sovereignty were breached</u>. China was forced to cede Hong Kong to the British and acquiesce to the stationing of British warships in the Treaty Ports.
- <u>The Chinese economy was devastated</u>. Drastic reductions in import duties and the ensuing massive volume of trade shattered Chinese industries, destroyed the textile industry through the influx of cheap, western machined produced products and triggered a monetary crisis.
- <u>The Manchu Rulers of the Qing Dynasty were discredited</u>. By signing the "unequal treaties" at the conclusion of each Opium War without exhausting all possibilities of resistance, the government demonstrated that it could not represent and protect the interest of the Chinese people in either the international or domestic arenas.

To the Chinese, the Opium Wars and the period of "unequal treaties" were shameful and degrading. Humiliated by the social chaos and the weakening of the Manchu rulers, Chinese intellectuals resolved to make China strong. The lessons these intellectuals gleaned from this period in their history formed the basis of a policy of "self strengthening." Prior to the Opium Wars, the Chinese concept of western countries was vague and in some cases preposterous. A prominent intellectual of this period, Wei Yuan, proposed that in order to fight the west, China must learn from the West. The intellectuals believed that simply adapting western technologies and industries was not enough: China must undergo political reforms, private enterprises should be formed to compete in the market place, and China should learn the art of international diplomacy.[11]

The humiliation and lessons of the Opium Wars and the period of "unequal treaties" over 160 years ago are deeply rooted in the Chinese psyche. The lessons and experience of these wars still guide China's thought and conduct in its international relations in the 21st Century, particularly as it emerges as an economic power in Asia. Is China's emergence benevolent? Or is it prompted by a renewed sense of superiority, desire for self-protection, and Wei Yuan's counsel that the purpose of learning from the West, is to effectively fight the West? As China continues to grow in economic power and influence, there are indications that it has adopted a long-term competitive strategy vis-à-vis its relationship with the United States. As part of this strategy, it appears that China has identified the economic struggle as the Center of Gravity of this competition. Indeed, some might argue that the Chinese strategy centers on an "economic attack" against all four elements of U.S. national power in Asia - diplomatic, informational, military, and economic. Using this strategy, China can attack the diplomatic legitimacy of U.S. power and influence in Asia through the establishment of multilateral trade and security relationships throughout the region. It can attack the informational credibility of the U.S. through an information campaign focused on the message of creating an East Asian community that gives all states a collective voice for dialog in resolving disputes by promoting more regional cooperation in maintaining security to bring about lasting peace and stability through the establishment of a "new international political and economic order that is fair and rational."[12] China can also attack U.S. military power through economic means, thus forcing a diminution of United States military power in Asia and a relative change in the "correlation of forces" and regional influence and power in China's favor. Finally, this strategy will enable China to attack U.S. economic stability by gaining a position that permits it to threaten the growth and vitality of the American economy, as well as the economies of the major U.S. allies in the Asia-Pacific, by changing political and economic alignments in Asia. The worst case effect of such a strategy would be to make U.S. interests and economic power in Asia subject to Beijing's pleasure.

ECONOMIC ATTACK AND "UNRESTRICTED WARFARE"

In February 1999, two People's Liberation Army Colonels, Qiao Liang and Wang Xiangsui published Unrestricted Warfare: Assumptions on War and Tactics in the Age of Globalization. The ideas espoused in this document are a product of extensive Chinese study of the U.S. method of warfare in general with specific emphasis on the first Gulf War (1990-91) and Operation "Desert Fox" (December 1998). Their study identified weaknesses in what appeared to be overwhelming U.S. superiority. Based on their assessment that China will be disadvantaged both qualitatively and quantitatively in key aspects of traditional military competition with the United States for the foreseeable future, this Chinese approach of "unrestricted warfare" focuses on what the authors call a "new concept of weapons," which proposes innovative or asymmetric ways of employing existing weapons and methods, rather than the development of "new-concept weapons" which they define as new high technology weapons developed to implement new or evolved strategy. According to "unrestricted warfare," whatever provides benefits to mankind can also be turned around to be a weapon to harm mankind." [13] With this in mind, the authors advocate avoiding high technology arms races. Their reasons for this are two-fold. First, an arms race places an undue economic burden on a country to maintain a competitive position in the highly dynamic and vulnerable area of "new-concept weapons" design and development. And second, over-reliance on high technology battlefield oriented weapons limits the country employing the weapons in its ability to effectively act against a lower technology - but innovative and resourceful - asymmetric threat through the full spectrum of conflict, to include the diplomatic, information, military and economic instruments of power. The authors go on to state that "To our way of thinking, a planned stock market crash, a computer virus attack, making the currency exchange rate of an enemy country erratic, or spreading rumors on the Internet about the leaders of an enemy country, can all be thought of as a "new concept of weapons."[14] Relying on these ideas, the Chinese seem to have adopted a predominantly asymmetric competitive strategy towards the United States - a competitive strategy – which in the spirit of Sun Tzu – is centered on achieving its objective while avoiding open or armed conflict. Notably, this strategy was formulated and adopted within the context of a Chinese perception that the United States is in decline as a Superpower, particularly in the aftermath of the terrorist attacks of 11 September 2001. Some Chinese believe that those attacks might even hold long-term benefits for Chinese economic growth. [15]

There are two specific indicators that China's strong economic emergence has been incorporated as a component of "unrestricted warfare." First, the Chinese have maneuvered other Asian nations and the United States, economically and politically, into relationships which are essentially “webs of economic dependence” upon China; relationships in which China holds significant advantages. Second, the Chinese have engaged in a strategy of economic opportunity denial and resource dominance in Asia.

CHINA’S “WEB” OF ECONOMIC DEPENDENCE

Over the past ten years, China has exhibited a manipulative economic and trade strategy with respect to currency valuation. Paradoxically, this has made China both a contributor to economic crisis and also a rescuer from its effects. In 1994, China devalued its currency by 33%. Many economists believe that this action had the net effect of significantly undercutting the export earnings of several Asian Countries at a time when their economies were already unstable due to internal mismanagement. Thus, the Chinese devaluation provided the final impetus for the Asian Financial Crisis of 1997-98. Significantly, as soon as the 1997 Asian Financial Crisis began, China pledged $1B to Thailand as part of an international aid package designed to bolster that country’s hard-hit economy. Later, Beijing pledged another $1B to Indonesia if Jakarta agreed to economic reforms demanded by the International Monetary Fund (IMF) as prerequisites for IMF assistance. China could make such pledges with relative ease because in the 3.5 years since devaluing its currency, it had amassed over $143B in foreign exchange reserves on which it could draw to assist distressed Asian nations and absorb any Chinese export losses. At the time of the 1997 crisis, the amount of foreign exchange reserves held by China was second only to the reserves held by Japan, $220B, and was more than those held by Germany ($77B) and the United States ($59B) combined. [16] In January 1998, Bao Kexin, the Director-General of China’s Department of Foreign Trade and Economic Relations, articulated Chinese strategy when he stated that China would be a “safe island that would provide financial stability to Asia in the midst of the crisis.” [17] This strategy gave China significant influence over many Southeast Asian Nations at a time when western capital was being withdrawn. One Thai businessman complained in the aftermath of the crisis that Beijing’s influence in Thailand, both officially and through Thai-Chinese business relationships, had become so pervasive that “Thai foreign policy is made in Beijing.” [18] Five years after it began, it was observed that the lingering effects of the 1997 crisis were such that the only way some Southeast Asian Nations would be able to compete with China would be to restore investment to pre-1997 levels. These nations, led by Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam and Timor Leste, all of whom make up the Association of Southeast Asian Nations (ASEAN), are encouraging this investment; however, in a way that is clearly beneficial to China.

THE CHINA-ASEAN FREE TRADE AGREEMENT

In 2002, Singapore's exports to China soared 33.1% while exports to the United States fell 7.9%; Malaysia's exports to China grew 10% that year while those to the U.S. grew by only 3%. [19] Indeed, Chinese economic ties with ASEAN are continuing to grow even closer. In October 2003, China and ASEAN Nations signed the China-ASEAN Free Trade Agreement (FTA) at the ASEAN Economic Summit in Bali Indonesia. Many observers agree that this China-ASEAN FTA has goals beyond mere economic integration. They believe the treaty is designed to provide greater Chinese regional influence and leadership at the expense of the United States. By the time this agreement – the goal of which is to remove all barriers to trade and investment among participants – is fully implemented in 2012, it is expected to raise ASEAN exports to China by approximately 50% and raise China's exports to the overall region by a similar margin.) [20] If this agreement plays out, China will significantly degrade the U.S. position as one of ASEAN's major trading partners by the beginning of the next decade. It is sobering to note that this FTA encompasses 1.7 billion consumers in countries with a combined gross domestic product of $2trillion, making it the largest FTA in the world in terms of population and potential for economies of scale and scope. [21] Although this FTA does not go into effect officially until 1 January 2005, a protocol was adopted at the October summit to implement an "Early Harvest" program" commencing 1 January 2004 whereby China will give early import privileges to ASEAN states on a host of agricultural products and limited manufactured goods. The list of agricultural products was finalized at the summit, however, individual ASEAN states will have to agree upon a list of eligible manufactured goods on a one-on-one basis with China. This is significant since China has little interest in importing manufactured goods but has a much greater interest in importing agricultural products given its growing water shortage. Notably, the "Early Harvest Program" is not beneficial to the Philippines, a major longtime U.S. ally and a key ally in the Global War on Terrorism (GWOT). Although the Philippines possess more than sufficient quantities of arable land to meet, and even exceed, the food requirements of its population, the prevailing weather patterns that Philippino farmers must contend with make it challenging to meet even minimum agricultural production requirements making it unable to benefit from agricultural exports to China or to practically any other country. Indeed Manila is a party to the "Early Harvest" Protocol and is eager to arrive at a "mutually satisfactory list of manufactured goods" for export to China. However, if the negotiations prove disadvantageous to the Philippines, they will not participate in the "Early Harvest Program" and will wait until 2010 when manufactured goods are included under the provisions of the China-ASEAN FTA. [22]

As China and ASEAN draw closer in their economic relationship, some observers have significantly noted that China is not just dominating non-hi-tech manufactures anymore; but with its rapidly expanding knowledge base, China is also positioning itself to dominate many hi-tech manufactures that have recently been the main source of exports for many ASEAN nations. If this trend continues, ASEAN nations will need to be wary of becoming net importers of Chinese products, which will draw them further into a "web of economic dependence" upon China. Indeed, as overall export industries have grown in China, many regional economies have begun exporting fewer finished products to the world market and have adapted to function as suppliers of either raw material or component parts to Chinese-based industry. The finished goods from Chinese plants are then exported by China to markets in the United States, Japan, and the European Union. [23] China's economic strategy not only has implications for ASEAN and other Asian nations in this regard, but also for the United States.

U.S. – CHINA ECONOMIC COMPARISON

In order to appreciate the degree to which the United States may become dependent upon China, the size of the two countries' economies must be compared. Consider the Gross Domestic Products (GDP) of the two countries. GDP provides a benchmark for a country's economic vitality by establishing a metric for the total amount of goods and services produced in a country during a 12-month period. It is calculated by adding together the market values of all of the final goods and services produced in a country and has the following quantitative characteristics: (a) It is a gross measurement because it includes the total amount of goods an services produced, some of which are simply replacing goods that have depreciated or have worn out; (b) it measures domestic production because it includes only goods and services produced within the geographic borders of the country whose GDP is being calculated; (c) it measures current production because it includes only what was produced during the year; and (d) it measures the final value of goods produced because it does not include the value of a product when sold by a producer, again when sold by the distributor, and again when sold by the retailer to the final customer; only the final sale is counted.

Comparison of GDP by Exchange Rate or Purchasing Power Parity

The GDP's of different countries may be compared by converting their value in national currency according to either (a) prevailing exchange rates on the international currency markets, or by (b) the purchasing power parity (PPP) of each currency relative to a selected standard (usually the U.S. dollar.) PPP theoretically asserts that in equilibrium the exchange rate that will prevail between two countries will be that which equalizes the prices of traded goods in each country. In this process, the goods considered in this metric are weighted according to their importance in the economy. PPP exchange rates are useful for comparing living standards between countries. Actual exchange rates can give a very misleading picture of living standards. For example, if the value of the Mexican peso falls by half compared to the dollar, the GDP measured in dollars will also halve. However, this doesn't necessarily mean that Mexicans are any poorer – if incomes and prices measured in pesos stay the same, they will be no worse off, assuming that imported goods are not essential to individual quality of life. [24] Measuring the economies of different countries using PPP rather than exchange rates helps to avoid this problem. The relative ranking of countries by GDP may differ dramatically depending upon which method is used.

Economic comparisons using official exchange rates can result in an understatement of the relative effective domestic purchasing power of the average producer or consumer within a less developed country by 50-60%, depending on the relative strength or weakness of the local currency on world markets. [25] However, on the other hand, comparisons based on the official currency exchange rates tend to yield a better indication of a country's purchasing power on the international market for goods and services. But, using either official exchange rates or PPP, the U.S. economy is the largest in the world. The United States accounts for approximately 21.1% ($10.7B) of the world $50.7T GDP.[26] Using the exchange rate, China's National Bureau of Statistics estimates that China will finish 2004 with a GDP of approximately $1.44T, an increase of 14.4% over 2002. [27] This figure makes China the world's fifth largest economy accounting for 2.8% of World GDP. However, measuring by PPP, China's GDP for 2003 is estimated to be approximately $6.16T; 57.6% of the U.S. GDP for 2003. [28] By this measure, China is not the world's fifth largest economy at 2.7% of world GDP. Rather, China is the world's second largest economy accounting for 12.1% of world GDP. By this measure of PPP, it is followed by Japan (7.1%), India (4.8%) and Germany (4.4%).[29] Additionally, whereas the U.S. GDP is forecast to level off at approximately $10.9T through June 2004, the Chinese GDP is conservatively projected to continue to increase by 4% during the same six-month period and at a minimum 7.5% year-on-year for the foreseeable future. [30] So, according to either measure, the national power conferred on China by virtue of the sheer size and continuing growth of its economy should not be discounted nor underestimated at any level. Without doubt, China's economic vitality offers this huge Asian nation significant freedom of movement on the world stage. Indeed, China's emerging economic strength could ultimately restrict the options and movement available to the United States and its allies in the Asia-Pacific.

THE U.S. – CHINESE ECONOMIC RELATIONSHIP: "WEB OF DEPENDENCE"

Whereas it appears that China's strategy is to achieve the dependence of Asian Nations through export dependence, China's strategy for drawing the United States into a "web of economic dependence" appears to be somewhat different. It centers on achieving significant advantage through a monetary policy of preventing China's currency from being traded on the world market and maintaining it in an undervalued status by as much as 40%, and a systematic long-term transfer of capitol – monetary, human and intellectual – from American to Chinese markets.

Currency undervaluation is not an uncommon economic strategy. During the 1980s, the Japanese undervalued the Yen. Periods of undervaluation usually coincide with periods of rapid economic growth in order to make exports more competitive on the world market. However, long-term undervaluation often results in unbalanced economic growth and inefficient domestic industries since the undervaluation artificially "props up" a country's exports and degrades the competitiveness and affordability of imports. Although reasons for undervaluing currencies vary, the effect of the undervaluation on the international market depends on the size and relative insularity of the undervaluing country's economy, as well as its long-term economic strategy. Generally, three effects will result in proportion to the undervaluation: exports will become more competitive; imports will become less competitive/affordable; and if the country chooses, foreign currency reserves can be increased significantly. While it is true that the accumulation of foreign currency reserves in and of itself does not confer power upon a country, it can add significantly to a country's <u>potential</u> power.

THE UNDERVALUATION OF CHINESE CURRENCY

The Chinese currency, the Yuan – also known as the renminbi, or "peoples money" – has been fixed at about 8.28 to the U.S. Dollar since 1994. It is allowed to fluctuate, but only in minute increments – a fraction of 1 percent – and in government controlled trading.[31] Ostensibly, China offers two principle justifications for maintaining this policy (despite extensive pressure by the U.S. and other governments to revalue its currency). First, the Chinese Government asserts that it cannot afford the risk of letting the Yuan trade freely on the world market until China's evolving hybrid socialist-market system develops institutions of sufficient strength and maturity to guard against damaging currency speculation. Second, the Chinese believe that the increased competitiveness conferred on their exports by an undervalued currency is essential to providing jobs to millions of workers who might otherwise be unemployed and thus become a potential source of social instability.[32] By some estimates there are as many as 36 million unemployed workers in Chinese cities. Additionally, the Chinese National Bureau of Statistics estimates that approximately 50 million new workers will enter China's workforce by 2005.[33] This reasoning notwithstanding, Chinese monetary policy holds significant negative consequences for the U.S. economy.

The U.S. – China Trade Deficit

The U.S. – China trade deficit for 2003 was $124B.[34] This figure amounts to 25.4% of the record 2003 U.S. – World trade deficit of $489.4B.[35] By the end of 2005, the U.S. – China deficit is projected to more than double to $300B.[36] For the month of October 2003 alone, the U.S. – China trade deficit was $13.6B; the largest monthly trade imbalance the United States has ever recorded with any country. During that month, the U.S. exported $2.9B worth of goods to China while it imported $16.4B.[37] These deficits result in large part from China's undervalued currency, which gives their exports substantial price advantage on the international market by making them significantly cheaper, while imports to China are more expensive. Additionally, China still maintains significant tariffs on many manufactured goods. Attempting to establish a spirit of economic cooperation with the United States, China recently proposed an initiative to further reduce the U.S. China bilateral trade deficit.

In October 2003, the President of the China Council for the Promotion of International Trade, Wan Jifei, proposed reducing the U.S. – China trade deficit through the increased export of high technology electronics, aviation and chemical industrial products from the United States to China. However, in the opinion of some observers, this was a dubious proposal because the U.S. has sought to restrict the export of these categories of products because of their convenient utility in modern military applications. Irregardless, the Chinese are urging the United States to change it policies in this area.[38] This proposal reflects Chinese understanding that the United States is constrained in its ability to force changes in Chinese trade policy for two reasons. First it is dependent upon cheap Chinese imports to suppress inflation and thus interest rates, while its economy struggles towards recovery. Second, the U.S. is becoming more dependent upon Chinese purchase of U.S. securities to finance an ever growing budget deficit, particularly as the Bush Administration seeks to finance a Medicare Prescription Drug Benefit and reinvigorate the Space Program with the ultimate goal of a manned mission to Mars. In this context, the Federal Budget Deficit for Fiscal Year (FY) 2005 is expected to be a record $520 billion; a $145 billion increase over the FY-04 budget deficit.[39] This budget deficit is largely a result of the sluggishness in the U.S. economy. This sluggish behavior has again come to the forefront as U.S. GDP growth for October through December 2003 reflected a 4% growth rather than the 4.8% growth forecast by analysts. This fourth quarter GDP performance was down from the 8.2% growth recorded in October 2003. [40] This erratic economic performance, which consistently borders on a slowdown, is perpetuated by the $489.4B total U.S. – World trade deficit, of which 25.4% was attributable to China in 2003.[41] Although overall U.S. exports were up 4.6% during 2003 to $1T[42] and the U.S. – China trade deficit decreased to $9.9B for the month of December,[43] these events were largely accomplished through the devaluation of the dollar, down over 20% against the Euro since 1 January 2003.[44] Although this devaluation has made U.S. exports more competitive on the world market, it has had only a fraction of the desired effect on the U.S. trade imbalance with China because the Chinese continue to peg their currency to the dollar, so the Yuan maintains parity with the dollar despite fluctuations in the dollar's value.

The Transfer of Monetary and Human Capitol to China

U.S. companies are investing extensively in China. In fact, recent analysis indicates that these companies are not merely investing in China, in many cases, they are transferring intellectual capitol, pathways, networks, and even factories. This phenomenon is not just affecting "blue collar" and low technology manufacturing sectors, but has now begun to impact "white collar" and high technology sectors. The lure for investment in China is low labor costs that average as low as one twentieth of labor costs in the United States. A worker in a Chinese factory typically earns an average of .86 cents per hour while the same worker would earn anywhere from $8.50 to $20 per hour in a U.S. factory. [45] Fueled by a large pool of highly educated workers and the prospect for per capita income to more than double over the next 15 years, the Chinese economy has absorbed over 800,000 high technology U.S. jobs over the past decade and is poised to absorb even more. In August 2003, INTEL announced plans to build a $375M semi conductor factory in Chengdu, setting the stage for China to become a world leader in the production of semiconductors. Additionally, General Motors has launched a flagship plant in Shanghai and has recently shifted to 24 hour production to keep up with demand as Chinese workers turn in their bicycles for automobiles and make China the fastest growing automotive market in the world.[46] Many global economists predict that this trend will only continue – projecting that over the next decade, over half of the growth of Fortune 500 Companies will come from China.[47] There is no doubt that China is capable of absorbing a virtually unlimited number of "white collar" jobs. One high-ranking Chinese official recently cited

China's goal of providing high quality college educations to 20% of its population by 2020. This equates to approximately 330 million highly educated people capable of performing at virtually all levels of business and industrial leadership and management at approximately one tenth of what their counterparts in the United States would earn. Although the growth opportunity presented by such a highly educated work force will translate into profits for companies investing in China, if experience to date is any indicator, it will not translate into jobs or strengthening of the industrial base for the U.S. economy. In this light, this capitol transfer poses serious national security concerns for the United States.

China's Buildup of U.S. Foreign Currency Reserves

The substantial U.S. trade imbalance, combined with surging U.S. investment, has enabled China to amass $364B in foreign currency reserves as of 30 September 2003. [48] At a time when the United States is being drawn into running record budget deficits in order to shepherd a sluggish economy towards future recovery while financing the GWOT, these enormous foreign currency reserves have provided China the opportunity to buy record amounts of U.S. debt in the form of U.S. Securities. As of 30 September 2003, China held over $122B of U.S. debt, second only to Japan, which owns a portfolio worth more that $440B. This amount of U.S. debt held by China has increased 20% since January 2003, and 150% since January 2002. China now holds 9% of the total U.S. debt held by foreign nations.[49] At first glance, 9% might not seem to be a significant amount. However, Asia currently holds approximately one-half of the world's currency reserves, approximately $1.5 trillion. By 2008, it is estimated that Asia will hold two-thirds of the world's currency reserves. To date, the U.S. has been able to count on the in flow of a much as 80% of Asian reserves into U.S. securities which are used to finance the U.S. national debt ($6.6T) and yearly budget deficits.[50] Potentially, China's rising influence in Asia will not only put them in a position to influence the U.S. economy through the amount of U.S. debt they hold directly, but also through the amount of debt held by the nations surrounding the "New Middle Kingdom" - nations which the Chinese might control indirectly through a "web of dependence" and multilateral agreements such as the China-ASEAN FTA. In such a scenario, the percentage of U.S. debt held by China would be exponentially greater than 9%.

Is such a level of Chinese influence far fetched? Maybe not. At the Forum of Asia-Pacific Economic Cooperation Finance Ministers on 5 September 2003, a majority of finance ministers rejected U.S. Treasury Secretary John Snow's call for revaluation of the Yuan and a "flexible" Chinese exchange rate. The Forum's joint statement provided support for Beijing's position and “appropriate exchange rate policies that facilitate orderly and balanced external adjustment.”[51] Another possible manifestation that Chinese economic power and influence are translating into political power, is evident in Singapore’s decision in September 2003 to relocate at least part of its military training facilities it had held in Taiwan for more than two decades to Mainland China. Significantly, China may attempt to apply similar economic-political pressure on the United States. A high-level Chinese official recently remarked to a U.S. military commander in Asia that in china’s view the U.S. would be highly constrained in responding to an aggressive move by China against Taiwan because the U.S. and China are so economically interdependent.

Taken to a logical - though worst case – conclusion, such influence puts China in a position to negatively or coercively affect the U.S. economy – and by extension its foreign policy – indirectly through trade policy but also directly through monetary policy by taking calculated actions that could cause fluctuations in the value of the dollar, ranging from the selective sell-off of U.S. securities to the wholesale “dumping” of dollars on the world market. Such action would have a severe impact on the U.S. economy – 70% of which is based on consumer spending[52] – in terms of increased inflation and interest rates in the short term and a potential replacement of the dollar as the international standard currency in the long-term.

ECONOMIC OPPORTUNITY DENIAL AND RESOURCE DOMINANCE

Some claim that China’s behavior and strategy on the world economic stage are nothing more than the result of sound economic decisions focused on seizing opportunities and growing their markets. However, as China’s economy continues to expand, its requirement for natural resources to fuel that expansion will also grow. The natural resource that will be key to the continued expansion of Chinese economic power is crude oil.

CHINESE CRUDE OIL REQUIREMENTS

A net importer of crude oil since 1993, China will surpass Japan in 2004 to become Asia’s largest – and the world’s second largest – consumer of crude oil.[53] In 2003, China consumed on average 5.4 million barrels of crude oil per day (BPD). Of this total, an average of 1.99 million BPD (36.8%) were imported. Furthermore, over the past ten years, since production at its key oil fields leveled off, China’s crude oil imports have increased on average 15% per year. During this same period, Chinese crude oil consumption has grown an average of 5.77% per year, while its domestic oil reserves grew by a total or only 1.67%.[54] Clearly, China’s 8% average yearly economic growth is being fueled in large part by its substantial consumption of crude oil at a rate that far outstrips the ability of its current domestic and international sources of crude oil to sustain over the long term. How will China continue to meet its demand for crude oil? It seems that it has identified two principal sources - Russia and the resource rich South China Sea.

Sino - Russo Oil Agreement

On 28 May 2003, China signed an agreement with Russia that – if carried out – will provide for the supply of 600,000 barrels of crude oil per day via a 2,400 km pipeline from Russia. This agreement was made to the disadvantage of Japan, the principal U.S. ally in Asia, which was negotiating with Russia on the construction of a 4,000 km pipeline that would have provided Japan with 1M BPD. Despite Japan's offers of substantial investment in the development and construction of the pipeline, the Russians deferred further consideration of this proposal until 2020, when sufficient crude oil reserves will be developed in Eastern Siberia to supply both the Chinese and Japanese pipelines simultaneously. [55] However, Japan recently revived its pipeline proposal to Russia by offering to finance the entire cost of its proposed pipeline and provide an additional $2B to develop untapped Eastern Siberian oil fields. Although Russia wishes to create better ties with China to shore up its international stature and avoid costly confrontations with China, it nevertheless is weary of China's growing power and its ambitions with regard to Russia's eastern provinces. Offering an interesting insight into Chinese strategy, Sergei Grigoriyev, the Vice President of the Russian state-owned pipeline operator Transneft, state that "We can get immediate dividends from choosing the Chinese route, but we would be tied to one country and would find ourselves at the whim of their policy."[56] Consequently, Moscow informed Beijing in September 2003 that it had decided to postpone the Sino-Russo oil agreement pending further evaluation. Russia will make a final decision in the spring of 2004. Although the Russians are re-evaluating their agreement with China, it appears that China is exerting considerable effort to outmaneuver Japan in it proposed oil agreement with Russia.

Chinese Crude Oil Requirements and the South China Sea

The second source of crude oil the Chinese have apparently identified is the South China Sea, particularly the Spratly Islands area. Although the Spratly Islands are little more than a large area of barren, partially submerged islets and reefs, their strategic importance lies in the fact that sovereignty claims to them are used to bolster claims to the surrounding South China Sea and its resources. By 2025, crude oil consumption among developing Asian nations is expected to more than double to 29.8M BPD, and natural gas consumption is expected to more than triple to 21 trillion cubic feet (Tcf) per year; projected Chinese consumption is expected to account for 33% of the increased crude oil consumption and over 50% of the increased natural gas consumption.[57] The U.S. Geologic Survey (USGS) estimates that the Spratly region holds approximately 28B barrels of crude oil. Accurate estimates of the quantity of natural gas held in the region are not available, but the USGS estimates that approximately 60-70% of all hydrocarbon resources in the South China Sea are in the form of natural gas.[58] As substantial as the USGS estimates are, Chinese estimates indicate that the South China Sea holds as much as 213 billion barrels of crude oil and 2,000 Tcf of natural gas.[59] These estimates warrant a high level of Chinese strategic focus in the South China Sea as a strategic resource area. And China is adjusting its regional relationships accordingly.

In the past, two issues would have prevented these hydrocarbon resources from being exploited: the deep-sea drilling technology required to access the deposits in depths as great as 2,300 meters, and the contested sovereignty of the region. The Spratly Islands are claimed by the Philippines, Brunei, Malaysia, Vietnam, Taiwan and China. The technology problem has been solved. The latest commercially available deep sea drilling technology has allowed exploration at depths as great as 3,000 meters in the Atlantic Ocean. And China is making a strong effort to solve the sovereignty issue.

China is building on the progress they have made in relations with ASEAN through the China-ASEAN FTA as well as China's accession to the Treaty of Amity and Cooperation, which specifies norms for relations between ASEAN members. These norms include mutual respect for sovereignty and territorial integrity of signatory countries, non-interference in member states' internal affairs, and renunciation of the threat or use of force against other member states. In September 2002, China invited exploration bids from foreign oil companies in 12 oil and gas blocks in the Spratly area. In the spirit of the Treaty of Amity and Cooperation, China has proposed to transcend South China Sea sovereignty issues in this exploration effort by offering the other Spratly claimants shared drilling rights in all exploration efforts. Under this proposal, China will set aside the legalities of sovereignty claims until all oil and gas reserves have been exploited.[60] As a confidence building measure - given that China has openly flouted sovereignty claims to the Spratlys at its convenience for three decades - China has also proposed the establishment of a Joint-venture Resources Management Body with rotating leadership among claimant states. Despite this offer, skeptics point out that China's relative overwhelming naval and economic superiority renders the other claimants helpless to be much more than a rubber stamp for Beijing's policies. Given the geographic dispersion of the oil and gas blocks marked by China for exploration, China would essentially hold sway over the entire Spratly Islands area as well as the continental shelf at the southern end of the South China Sea. Given the extent of this area, China would not only secure the oil and gas resources of the region but also be in a position to virtually dominate a key global trading route.

CONCLUSION

Since the Chinese economy has grown to be the second largest in the world - as measured by PPP – and with its prospects for greater growth over the next fifty years, the United States, as the world's largest economy and the leader of the free world, cannot avoid engaging China economically. However, the United States must approach its economic relationship with China with "eyes wide open" and focus on safeguarding U.S. national security interests at home and abroad. We must realize that China's economic policies toward the West - and its strategies for implementing those policies - are in large part a product of its historical experience. The Opium Wars and their aftermath continue to significantly influence Chinese economic interactions with the West. We must acknowledge China's determination to never again permit the humiliation of the "Period of Unequal Treaties;" the imposition of a semi-colonial/semi-feudal state, the breaching of China's territorial integrity and sovereignty, the devastation of the Chinese economy, and the discrediting – and resulting downfall – of its ruling government. The Chinese intellectual, Wei Wan's admonition to 'learn from the West in order to fight the West' is arguably the foundation of the Chinese approach to "Unrestricted Warfare." In many ways, this approach is based on exploiting opportunities - exploitation that follows a path of least resistance and that holds the greatest advantage for China. Many believe that China views its economic competition with the United States as a "zero sum game." According to this view, China sees any opportunity gained in its interests as an opportunity no longer available to the U.S. in support of its interests. Therefore, exploiting all opportunities – diplomatic, informational, military and economic - is advantageous to China's long-term strategic objectives. In spite of this view, the United States can successfully interact with China. However, such interactions will require a carefully crafted and executed strategy that employs strategically applied "pushback" at the right times and in the right places. Through such a strategy, the U.S. can successfully engage China on equal terms in a relationship of mutual respect. In the long term, such an engagement strategy will deny China the opportunities to exploit our economic relationship in ways that are detrimental to U.S. national security interests. In its engagement with China, the United States must avoid setting the stage for miscalculations, that in the worst case, could result in armed confrontation whether it be in the Taiwan Straits, the South China Sea, Indian Ocean or even in the Western Hemisphere. The following recommendations support a U.S. policy of strategic "pushback" towards China. The U.S. must:

- Reduce the U.S. budge deficit by 75% over the next six years, reducing it to a manageable level without over-reliance upon extensive foreign purchase of U.S. securities.
- Commit to reducing the U.S. trade deficit by 50% over the next ten years. To accomplish this, the U.S. must leverage all resources of the WTO to force compliance by China (and all member nations) with fair trade practices. Additionally, the U.S. Government must stem the export of key elements of the strategic manufacturing base and "white collar" jobs.
- Emphasize multilateral as well as bi-lateral economic and security frameworks in the Asia-Pacific. Key to this effort will be strengthening the U.S. relationship with ASEAN, the ASEAN Regional Forum and reinvigorating the Asia-Pacific Economic Cooperation Forum. Through this action, the U.S. will be able to leverage all elements of national power to thwart Chinese efforts to attack the <u>diplomatic</u> legitimacy of U.S. power and influence in the Asia-Pacific; counter China's <u>information</u> offensive centered on creating a new economic, political and social order in Asia - described by China as "fair and rational" - and counter China's attack on U.S. <u>military</u> strength through its "<u>economic</u> encirclement" of the United States and its Asia-Pacific friends and allies.
- Spearhead development of alternative energy sources with the goal of reducing U.S. and allied dependence on crude oil by 50% over the next 20 years. China should be given the opportunity to be a full partner in this effort.
- Commit to maintaining dominant military presence in the Asia-Pacific through 2050.

China has incorporated its economic power as a component of its strategy of "Unrestricted Warfare." It is executing that strategy now in the form of an "economic attack" against all four elements of United States national power in the Asia-Pacific. By adopting a strategy of "strategic pushback," the United States can "meet, check, parry, and thrust" any Chinese efforts at economic "Unrestricted Warfare" and take positive steps towards building a firm yet productive relationship with China - one in which U.S. national security interests are adequately protected.

WORD COUNT= 8,856

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